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REMEMBERING THE FUTURE

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Systemic Crises- A Historical Analysis 1340-2012

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Part I: Crisis History and "Evil" Markets

It is widely believed that the current crisis has no precedent. That it is a first time phenomenon and the result of "evil" markets and conniving bankers conspiring to attain world domination.

Many refer to the end of an era, attributing the global financial crisis to a logistic miscalculation which will precipitate the end of capitalism. Others, after serious reflection have now unveiled the looming threat of 'Derivative instruments'.

The Crisis, however and the Debt are as old as mankind.

How many know that the evil markets and big banks date back to ancient times and the Middle Ages?

How many know that the *first recorded European Debt Crisis* happened as far back as 1340 when the King of England defaulted and ceased servicing sovereign debt which had a ripple effect and unprecedented domino effect on three big hyper banks (European super companies) based in Florence of the medieval times.

How many know that the *first stock exchange bubble* manifested itself in the first capitalist country, Holland of 1637? It was a by-product of the infamous Derivatives, in the form of fixed term commodity contacts – Commodities Futures – on no less than tulip bulbs whose value came to exceed that of an average house on Amsterdam.

How many seasoned critics know that the aforementioned derivative crisis and recession that followed had a catalytic effect on the other side of the Atlantic a few years later?

How many know that today's metropolis of capitalism could have still gone by the name New Amsterdam and not New York had its Dutch colonists, under the recessionary impacts following the Crisis of 1637 not been forced into selling it to the British for a fraction of its value?

How many critics of Colonialism and admirers of the First Democracy instituted by George Washington, know that the Boston Tea Party of 1773 the instigator of the 1776 revolution, was but a side effect of an earlier crisis in 1772 in the far away colony of the British Empire, Bengal?

How many believers in the humanitarian symbolism of the French Revolution know that hidden behind the revolutionary proclamations of 1789 was a national bankruptcy one year prior, the last of a series of five consecutive sovereign debt defaults declared by the French Kings before losing their throne and their heads at the guillotine?

How many who know of the famous Alan Greenspan and the Federal Reserve (Fed) would also know the long-forgotten true American hero Alexander Hamilton, the creator of the First Central Bank in the USA in 1791, rescued the newly founded country from certain bankruptcy?

If the Finance Minister of the time had not tackled the first debt crisis in the aftermath of the War of Independence and saved the American banking sector by injecting liquidity and driving creditors into a voluntary haircut on US government bonds, perhaps it would be the British Empire that holds world dominance to this day.

How many know that for 30 years on the then financial center of the world, London was frantically trading mining stocks & government bonds of Latin American countries but also trading the non-existent concocted state profiteers named Pouagais ?

How many know that in 1825 the Bank of England exhibited the same lack of judgment and resolution in tackling this profiteering as today's central banks have? The result was that not only did investors loose their money and the BoE threatened with insolvency but that almost all the counties of Latin American defaulted as did most of Europe - at the time the term globalization had still to be determined.

Respected scholars such as Stiglitz and Roubini admit that the common characteristics of cyclical crisis start with high borrowing levels that leads to asset bubbles, and then end with the unavoidable bankruptcy, in every corner of the earth and over thousands of years.

History repeats itself once again!

Man's greed is as old as the human race, excuses and scapegoats also.

Replacing the witches, heathens, heretics and … elves who are blamed for the consecutive bankruptcies, the costly war campaigns of the Medieval Ages and the exorbitant spending of the Royal Courts found their demons in the 'evil markets' and the villainous profiteers. As if the latter did not exist in so called 'good times' when governments and the likes, wastefully spent the limited resources of an economy with irresponsible spending by turning a blind eye to the speculation around them.

Let those new found analysts who predict doom, take a brief view of past precedent rather than go on a witch hunt as has been done during every crisis from the times of the Medieval Kings to today.

Nothing is more to blame for the Good old times than our bad memory!

Part II: Ideology or Leadership?

It is widely acknowledged that the Germans had a hand in the two great catastrophes of Europe in the 20th century.

Fewer however know that Germany was the nucleus of the greatest world financial crisis of the 19th century; that of 1873.

Three years after the end of the war between Prussia and Germany (1870-71) and the institution of a unified German State, the mass euphoria and optimism over the war compensations paid to the German victors by the defeated French spurred the greatest speculative real estate bubble known to Europe. The rapid rise in the prices of German real estate and other asset values in Central Europe ended in the inevitable crash of the Vienna Stock Exchange in 1873.

Waves of panic swept across every corner of Europe. Then across the Atlantic long before the term globalization was conceived and included in official terminology.

The American economy which was expanding at break-neck speed riding on the "railroad fever" boom at the time was dealt a severe blow when funds began repatriating to Europe and panic hit the investing public when the well-known banker J. Crook failed to raise funds to cover the debt issue of the US railroad company Northern Pacific. Values plunged on both sides of the Atlantic precipitating a worldwide recession which lasted a long time and accelerated bankruptcies of railroad companies. This signaled the end of an era of coal and the transition to the age of oil and the automobile.

The world economy and the developing capitalistic system experienced many crises until the big crash of 1929.

However, history would have perhaps been re-written differently if the great American banker J.P. Morgan had not successfully dealt with a lesser known but equally serious crisis in 1907. A stock exchange crash ignited the crisis which soon turned to mass panic across the land and spread all the way to Japan and Egypt.

Few analysts doubt that World War I would have happened earlier had J P Morgan not locked up the most powerful bankers of New York…throwing away the key! Unorthodox in his ways but having put down his own money first, acting as an unofficial lender of last resort, he forced them to change their negative stance and provide the needed injection of liquidity to a crumbling financial system one which was one step from bankruptcy.

So much has been written about The Great Crash of 1929 and the long depression which lead to World War II that little could be added in a few more lines. It is however worthy to note that during the crisis of '29 the Lender of Last Resort was no individual banker but the Central Bank the well -known FED which had been founded on December 23, 1913 a few months after the death of J.P. Morgan. Politicians and public officials holding crucial positions in the FED may have termed as 'intentional financial policy of non-intervention' their cowardice to grab some influential bankers of the time by the collar. The president Herbert Hoover publicly declared at the time that "..the worst is behind us.." only for another 6,000 US Banks to go bankrupt, multiple sovereign bankruptcies and the forced exit from the Gold Standard.

Advocates of Keynes and Freedman have argued since about the handling of the crisis and the effectiveness of the Keynesian 'New Deal' of President Roosevelt who succeeded Hoover. Perhaps the final answer will be given a century later with the containment of the current crisis.

The experience of the great crisis of the years between the world wars teaches that the recession of 1929-1933 was contained temporarily in 1934 by the measures of the Keynesian model.

With the expansionist measures of the Keynesian model only for the recession to reemerge more sever several years later in 1937-1939. It could not be overcome but with the outbreak of a catastrophic world war. Could the key to the management of a crisis be a matter of ideology or a leadership with courage and conviction to push some and throw away the key?

Part III: The Leadership of Paul Volcker

The 15th of August 1971 was a day that changed the world. Behind the shock of President Nixon's announcement of the de facto exit from the Gold Standard there was an effort to save the US from unofficial bankruptcy and thus save the planet from another depression.

The USA could not honor its debt payments in gold towards its creditor countries, as it had promised to do since the summer of 1944 at Bretton Woods. Its gold reserves were no more than 7,500 tones while its commitments were 22,000 tones.

The era of stable exchange rates of Bretton Woods I, gave way to a period of fluctuating exchange rates and a dollar that was under attack given that it was on the road to becoming a fiat currency. Inflation raised its ugly head and rose to levels not seen since World War II. The undeclared 'Cold War' was not going very well for the Atlantic Power. The Vietnam War had proven a very costly war and was coming to an auspicious end - the US defeated and the USSR a strong militant empire gaining territory in every corner of the world.

Prophecies about the imminent demise of capitalism resounded with newfound vigor. The oil crisis of 1973 seemed to be the …shot. Western economies were struggling under the strain of the rapid rise in the price of oil due to the embargo placed by Arab nations. Long queues at the gas stations came as the biggest shock to the unknowing American citizens since Pearl Harbor. Was there any connection between the abandonment of the gold standard and the oil crises of the 1970s? The recession and inflation which followed were to change the western way of life.

The years of growth after the wars 1950-1960, with the real increase in workers' pay and the establishment of the modern welfare state seemed to give way to the ghost of stagnant economies suffered with inflation and social upheaval as well as unseen organized violence which reappeared after decades of social peace.

The strike in England of 1974 took down the government of E. Heath within several weeks. US dominance was being questioned for the first time within Latin America itself.

A second oil crisis in 1979 sent the price of oil and gold to new highs. The overthrow of the pro American Sheik of Persia and the Soviet invasion of Afghanistan dangerously increased the geopolitical instability. The West only knew up to 1979 to print money as the panacea to its problems. It however did not seem to be able to impede (or restrain) the crisis or the Soviet assault which was being funded by the historically high price of oil and gold both of which the red empire was capable of producing in abundance at the end of the 1970s.

Who could have predicted that in just a decade the anticipated victor of the Cold War would crumble with a thud and the bipolar world would give its place to an economic and military monopoly of the metropolis of capitalism?

Perhaps none other than Paul Volker. The man who rescued capitalism from its 1970s downward spiral with an acute shock. Interest rates almost doubled between 1979 and 1981 while inflation from 13.2% in '81 fell to 3.2% in '83. The uncompromising Volcker once again changed the rules of the games, as he had done before. It was not the first time that Paul Volcker saved the US. It was however the first time he had faced a world-wide systemic crisis, provoking an even greater crisis which hit both the heavily indebted Third World but only after it hit the very heart of America. The increase in interest rates made it very hard for Latin American countries to pay down their debts as did the developing countries in the Third World. One-by-one they went bankrupt taking with them in a Domino effect some of US banks. The systemic debt crisis of 1982 added yet more instability to the world financial system.

Cheap money became a thing of the past as did countless mortgages handed out for years by small mortgage lenders in every state.

In the mid 1980s growth returned and the indexes measuring sociopolitical instability fell dramatically across the western world which was dynamically regrouping. The high prices of gold, oil and commodities that fueled the income of the Soviet Empire showed rapid decline. America no longer restrained by the Gold Standard, could finance its costly armament programs especially S.D.I known as "Star Wars" which destabilized the balance of power and the 'Mutual Assured Destruction dogma .

Volker's successor to the head of the FED in 1987 was Alan Greenspan. Greenspan – a major supporter of deregulation - faced a minor Stock exchange crisis on Wall Street in October 1987. Black Monday on Wall Street, which although severely shook the markets did not turn into a worldwide systemic crisis or halt the rapid growth of the real economy. On the other side of the pond, Afghanistan had turned into the Vietnam of the old Soviet superpower, which had embroiled itself in a ten year costly campaign against Islamic militants who were being financed handsomely by the West and its allies.

Two years after the departure of Paul Volker, the architect of the 'turnaround story', the great adversary of capitalism was falling apart (collapsing) from one side of Europe to the other . The leveraging and deleveraging of the free markets which A. Greenspan so believed in, produced their "miracle" by inflating like a balloon the quantity and speed of circulation of worldwide monies. The great winner was "paper" over gold, with paper money or "Fiat money" as it is known, surging across the world. The Gold Standard meanwhile seemed forgotten in the plethora of monies – even though the money had no actual value.

Is Gold really forgotten however, or merely waiting its turn to resurface, as it has done so many times in the long history of the planet?

Paper money was not an innovation of capitalism, but preexists from the time of the Chinese Emperors of the Song Dynasty a thousand years before.

The history of Gold predates even the history of mankind not to mention paper, a mere human invention.

Part IV: The Day After

The era of western hegemony which succeeded the bipolar world of the Cold War, is a time of successive crises that bring us up to the present.

The 1990s saw Europe, which was taking its first steps towards currency unification, in the throws of a systemic crisis known as the ERM Crisis, which culminated with an attack on Sterling (1992) and the permanent exit from the European Monetary System. The kudos and the profits from the devaluation of the British pound went to George Soros; the losses to the Bank of England. During the same period the Scandinavian countries were going through an acute banking crisis, which was to bring about a fundamental restructuring of the socio-economic model of growth with less governmental control.

The miraculous Japanese growth after World War II was also dealt a blow and violent shock, which turned 'The Land of the Rising Sun into a chronic patient of the world economy from the beginning of the 1990s until today.

The fall of Japan signaled at the same time the rise of America. A new economic cycle of growth began in 1992, in a euphoria of optimism which veiled the 'pessimistic' trap of increased liquidity to follow. Alan Greenspan monotonously warned the markets about the bubble being created every time the Dow Jones rose another 1,000 points. He however, took no further drastic measures to prevent it. On the contrary the infamous Greenspan put was exacerbated by his insistence on not regulating the derivatives marker (Summer and Rubin were the other co-heads of the committee that planted the seeds of the financial destruction that culminated in 2008).

The "age of turbulence" began with the crisis of the Asian Tigers in 1997.Within a matter of months they collapsed like paper castles. The following year elapsed; a break which proved unable to defend the world economy from the waves of the Russian crisis of 1998. For a second consecutive autumn the currency markets, shares and exchange rates were dealt a severe blow negating one more modern scientific myth. The 4.6 billion dollar losses of Long Term Capital Management (L.T.C.M) in four months from the outbreak of the Russian Crisis, invalidated every existing financial model as well as the dogma that computer i.e. Automated Trading Systems, can predict crises and continue to deliver results. Even guru s of the markets, such as the developers of the infamous L.T.C.M where caught unawares by the crisis of 1998.

The 1997 Nobel Prize winning economists Myron Scholes & Robert C.Merton found themselves on the edge of the cliff and had to be bailed out by a forceful Alan Greenspan, Head of the FED who characterized the L.T.C.M as "…too big to fail…" and '...too interconnected to fail..". The biggest US bank, under duress from the Fed, rallied to support the financial system and the L.T.C.M with several billion dollars. The critical rescue however, of such a large financial organization, such as L.T.C.M. perhaps signaled the beginning of the end for another much bigger one ten years later.

"…deals must be kept especially those not written on paper.." was the unwritten law on Wall Street, from as long ago as the Buttonwood Agreement, when twenty four brokers massed under the great oak on 68, Wall Street and founded the New York Stock Exchange in 1792. Perhaps no one knows better than H. Paulson at the time CEO of Goldman Sacks, who of the great bankers wavered and was less forthright in his commitment to support L.T.C.M in the autumn of 1998.

The stock exchange fervor of 1999 had an inauspicious end. The worldwide collapse of financial markets and the start of the dot.com bubble which blew up in 2000 took with it yet another popular fabrication of the era. The novel opinions of some analysts regarding the morphing of the normal economic cycle and the maintaining the P/E ratio at extraordinarily high levels, above the historic average, were robustly discredited by the hundreds of bankruptcies of overvalued high tech companies and the huge losses to investors that had believed in them.

The conservative investment approach of Warren Buffet prevailed once again while the value of gold, which had been neglected began to re-emerge from its historical lows of the 1990s. The Euro and currency unification of Europe, without prior fiscal and political unification made its debut marking the start of a new millennium.

The decade of 2000-'10 was, in hindsight, a lost decade for the stock markets. Not so for gold, however, whose value in dollars almost quadrupled, breaking the 1,000 dollar mark but not reaching its all-time high of the 1980s. The nominal value of $850per ounce in the 1980s allowing for inflation equals $2,271 per ounce today.

The bubble did not forego this decade either. The same circumstances that prevailed in 1637, 1825, 1873, 1907, 1929 and as in many other smaller crises – optimism –liquidity trap – leveraging - speculation- asset bubble and the inevitable collapse at the end, repeated themselves once more but on a greater scale. The Subprime Crisis 2007-'08 was the tip of the iceberg leading the world financial system, beset by the toxic debt, to be rescued by the governments of the USA, England even Switzerland and the United Arab Emirates.

Only one big financial group was not saved. The historic Lehman Brothers was the only one left to its fate by the then CEO of Goldman Sachs H. Paulson and the US Treasury in 2008. For the first time, an illustrious financial institution, which qualified for emergency funding (being very big and well-connected) was allowed to fail, taking with its fall world economies and international markets in an unprecedented crisis.

Even the Bank of England was saved at the last minute, during the world systemic crisis of 1825, with an injection of liquidity from Britain's traditional enemy, the French.

In the US printing machines and low interest rates supplied cheap money to the markets forestalling the recession. The Dow Jones climbed to its historic highs of 2007, in less than 3 years. The dollar fell against the euro reaching a level of 1.60 in July 2008. It did not remain so, as it jeopardized global balances and the necessary inflows of capital, essential for the viability of the US economy.

A small country of the European Union (accounting for 2% of EU GDP) seemingly insignificant to the world economy, as is Greece found itself defaulting on payments, activating the European debt crisis. The recession and debt crisis which began in 2010 until the present day, started from Greece and spread through Southern Europe, and may have arrested the cost for Germany, of the rise of the Euro, stabilizing the Dollar in a favorable exchange rate band around 1.30, for the US. However, this put the future of the European Union and the Euro in jeopardy. The introspective Greek economy though small, as a member state of the EU fulfilled the second prerequisite for the generation of a systemic crisis (…too interconnected to fail). It seemed though, that a country may not be as significant for the international financial system as a few of the biggest world banks which satisfy both clauses and the first in particular (TOO BIG TO FAIL).

The probability that the already strained financial system will withstand a repeat phenomenon like that of Lehman Brothers is less than that of 2008.

Maybe the first international debt crisis of 1344, when the bankruptcy of the king of England devastated the three Super Banks of Florence which had loaned him, in the so called domino effect, serves as a warning to modern central banks. No analyst can claim with certainty that the accumulation of so much wealth and power by the three super banks of the time, when one borrowed from the other (long before the appearance of capitalism), led to their self-destruction and the shift in the balance of economic progress from Southern European to the Anglo-Saxon North. It is, however, certain that had the distribution of risk been greater, the banks more in number and smaller in size and protected by legislation from the two … clauses of systemic risk (too big to fail, too interconnected to fail) the point of convergence of collapse of the then banking system, would have been much lower and sustainability much greater. It is never too late for changes as the lessons of the past are enduring.

Economic crisis come with organized forms of society and pre-existed the industrial revolution and the appearance of capitalism. Critics wrongly claim that only history repeats itself, so do crises. Man makes the same mistakes and nature corrects them. Each and every world systemic crisis does not mean the end of the world, but the end of an era and the beginning of a new even better one. Perhaps we would still be living in the age of coal and the railroad if the world wide systemic crisis of 1873 had not destroyed the over accumulated wealth in the railroad companies- goliaths of the time- forcing Man to turn to new sources of energy and signaling the resurrection of the oil producers and the petrol guzzling mode of transport such as the car and the airplane which in turn accelerated world growth. How would the world be today if a century later, following the timely warning of the oil crisis of 1973, we had not turned the flow of capital into research of alternative sources of energy?

How would the US have maintained its superiority in the 21st century without exploitation of new energy sources, achieved by utilizing the new techniques for utilization of cheap shale gas if capital was still accumulated in the heavy energy industries of Detroit?

The world systemic crisis started in the West and spread like a contagious virus raging to the east testing the US, Europe and the Middle East. It is highly improbable that it will subside before affecting the Far East and the rising industrial superpower, China in particular. We are living in the transition period, the end of the industrial era of 250 years and the beginning of a new long-lasting cycle, different as a worldwide model of less intensive development as by the profit of the postindustrial time Rifkin.

Esteemed economists like Stiglitz openly question the established methodology of measuring financial indicators such as GDP which does not take into account the effects that economic growth has on the environment.

The crisis, which classic linear models of the industrial era failed to predict and deal with, will not signal the end of the school of economic thought which considers that a parameter and subsystem of the Environmental System is the economy.

Old school economists dogmatically espouse the outdated theories of the 19th century. They ignore the overuse and squander of natural resources utilized for the economic activities of the Industrial Age and the cost of limiting the instability to the broader ecosystem which this intense economic activity produces.

The laws of nature are more powerful than the Laws of Man. Unfortunately for Man historic precedent shows that rarely are the Laws of Nature imposed without violent changes. Fortunately though, out of every crisis a better tomorrow is born.

The above is an excerpt from the pre-publication of a book by Manos Xionis. Manos Xionis is a consultant, shareholder& member of the board of several international companies in the financial, IT and energy sectors.